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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 126

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILADELPHIA TRANSPORTATION COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 17-37) is reported at 9 T. C. 1018. The opinion of the Court of Appeals (R. 97-99) together with the dissenting opinion of Judge Waller (R. 99-100) is reported at 174 F. 2d 255.

JURISDICTION

The judgment of the Court of Appeals was entered on March 21, 1949. (R. 101.) A petition for a writ of certiorari was filed on June 16, 1949, and was granted on October 10, 1949. The jurisdiction of this Court is conferred by 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

1. The taxpayer was incorporated on January 1, 1940, to effectuate a plan of reorganization under the Bankruptcy Act. Pursuant to the plan, the taxpayer acquired the assets of the debtor companies and issued its own securities in exchange. These included certain bonds issued on January 29, 1940, but dated January 1, 1939, with interest coupons attached. The taxpayer in 1940 redeemed interest coupons representing "1939 interest."

The question is whether the sums so paid represented "interest" which could, under Section 23 (b) of the Internal Revenue Code, be deducted in 1940.

2. The Commissioner made a timely deficiency determination for the taxable year 1942, in which he reduced the net loss which the taxpayer, under Sections 23 (s) and 122 (b)(2), Internal Revenue Code, carried over from 1940, and in which he disallowed the 1940 interest deduction referred to in question 1. At that time assessment and collection of any tax for 1940 was barred by limitations.

The question is whether, in making a timely deficiency determination for the taxable year 1942, the Commissioner is powerless to correct an erroneous carry-over from 1940, the loss year.[1]

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[1] This question is not raised by the petition for certiorari, nor was it passed upon by the courts below. However, respondent has raised this issue in support of its position, and may renew the point in its brief on the merits. If this Court should decide the first question in the Government's favor, it might then proceed to consider this second question, or it could remand the case to the court below for a consideration of this question.

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STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations are set forth in the Appendix, *infra*, pp. 33-35.

STATEMENT

The facts in this case are not disputed and are evidenced by a stipulation (R. 2-14), by a supplemental stipulation (R. 14-16), by certain exhibits to the stipulation (R. 39-95), and by other exhibits.[2] They may be summarized as follows:

The taxpayer was incorporated on January 1, 1940, to effectuate a plan of reorganization under the Bankruptcy Act. The plan was approved by the bankrupty court on November 14, 1939, and was given an effective date of January 1, 1939. Under the plan, the taxpayer acquired the assets of 65 companies which were merged and consolidated into the new company, the taxpayer. (R. 4-5, 7.)

On January 29, 1940, as part of the plan, the new company issued its consolidated mortgage bonds to holders of stock and stock trust certificates and to holders of bonds in certain of the old companies. These bonds were dated as of the effective date of the plan, January 1, 1939, and coupons were attached for "fixed interest" and "income interest," beginning with that date. (R. 5-6, 7-8, 46-48, 81-89.) Simultaneously with the issuance of the bonds, the taxpayer delivered to the trustee for the bond-

[2] Some of the exhibits have not been reproduced in the printed transcript of record, but are available in the record on review. Where necessary, these will be referred to by their exhibit numbers.

holders its check to redeem the "fixed interest" coupons for 1939. (R. 9-10.) On July 1, 1940, the taxpayer redeemed the "income interest" coupons for 1939, at the rate of 2.52 percent. (R. 10.)

In its tax return for 1940 the taxpayer, which filed its returns on the accrual basis, claimed as a deduction the payments which it made to redeem the 1939 fixed and contingent "interest" coupons.[3] The 1940 return showed a substantial net loss. This net loss was claimed as a deduction in the taxpayer's 1942 return as a carry-over from 1940 under the provisions of Sections 23 (s) and 122 of the Internal Revenue Code. (R. 12-13.) In determining the taxpayer's net operating loss carry-over for 1942, the Commissioner disallowed the deduction in 1940 of the "1939 interest," both fixed and contingent, giving rise to the deficiency involved in this case. (R. 13.)

The Tax Court, upon petition by the taxpayer, held that "the petitioner properly accrued and deducted in its income tax return for 1940, interest in the amount of $1,787,206.88 which it paid in that year." (R. 37.) The Court of Appeals affirmed, one judge dissenting. (R. 97-100.)

Facts relating to the reorganization plan which are particularly relevant to the nature of the pay-

[3] The taxpayer also deducted the amount which accrued during that year on the 1940 fixed and income interest coupons. This deduction was allowed by the Commissioner and is not in issue in this proceeding (R. 11-12), except to the extent that it is relevant to the question of the propriety of the deduction by a taxpayer on the accrual basis of "interest" for two years in a single year.

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ments sought to be deducted as interest are set forth in some detail under the first head of the Argument.

SPECIFICATION OF ERRORS TO BE URGED

The court below erred in holding that the taxpayer accrued an obligation for interest deductible under Section 23 (b) of the Internal Revenue Code where its liability was to redeem "interest" coupons which were predated, and which covered a period prior to the existence of any indebtedness of the taxpayer.

SUMMARY OF ARGUMENT

I

As used in the statute, "interest" means compensation for the use of borrowed funds. "Interest" cannot accrue with respect to a period during which there is no indebtedness. Where, as here, the taxpayer issued securities to effectuate a plan of reorganization, and where those securities were predated to conform to the effective date of the plan, the obligation to pay "interest" for the period which antedated the actual issuance of the securities was an added cost of acquiring the reorganization assets. It was not compensation for the use of borrowed funds, since there was no borrowing by the taxpayer during that period, and it is not a deductible item.

The lower court, in permitting such an obligation to be deducted as interest, allowed the tax-

payer to have a deduction for essentially the same items which were properly deducted by the predecessor company in a prior year. Moreover, treatment of the payment as interest permitted the taxpayer, contrary to correct principles of tax accounting, to deduct two years' interest in one year.

II

Even if the taxpayer's obligation to pay the predated "interest" could possibly be viewed as being deductible interest, the lower court, nevertheless, erred in permitting the taxpayer to deduct the full amount in one year. At the most, such an obligation would represent a prepayment of interest which must be deducted ratably over the entire life of the indebtedness, not in one year.

III

The Commissioner properly determined the amount of the taxpayer's net loss in 1940 which could be carried over as a deduction to the taxable year 1942. The deficiency determination for 1942 was timely. While assessment or collection of tax for 1940 was barred by the statute of limitations, the statute does not prevent a disallowance of a deduction claimed for 1940 where it affects the tax liability for an open year. Congress never intended that the proper amount of loss sustained in one year should be foreclosed from examination when it affects the tax liability for an open year.

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ARGUMENT

I

Interest on Indebtedness Which Is Deductible under Section 23 (b), Internal Revenue Code, Is Compensation Paid for the Use of Borrowed Funds. It Cannot Exist for a Period Which Antedates an Indebtedness. Here the Disputed Payments Were Capital Expenditures

A. *Introductory*

The problem raised by this and similar cases is whether a taxpayer can, by issuing a pre-dated obligation, purporting to bear interest during a period prior to the existence of any indebtedness, deduct as "interest" under Section 23(b) of the Internal Revenue Code sums which are in fact capital expenditures. The facts here presented show plainly that the payments sought to be deducted as interest were really capital expenditures. They certainly were not within the meaning of Section 23(b).

The interest which is deductible under the statute is compensation for the use of borrowed funds. There can be no compensation for the use of borrowed funds for a period during which no funds were borrowed. A payment which purports to be interest for a period prior to the indebtedness may —and does in this case—actually represent an additional cost incurred by the debtor in acquiring assets. Such a payment cannot be deducted as though it were interest on borrowed money. In other circumstances, it might represent a prepayment of interest or a discount of the obligation

which, for tax purposes, must be amortized over the entire life of the indebtedness. Whatever else it may be, however, such a payment cannot be considered as being interest for the prior period, and, if deductible at all, it certainly cannot be deducted in full in the year when it is paid or accrued. Analysis of the facts of this case shows the applicability of the foregoing principles.

The creation of the taxpayer corporation was the culmination of proceedings under Section 77B of the Bankruptcy Act; sixty-five corporations previously constituting the Philadelphia Rapid Transit System [4] were consolidated and merged into the taxpayer.

A "Second Revised Plan of Reorganization", originally proposed in 1937 and twice amended in 1938, was finally approved and confirmed by the district court on November 14, 1939. (R. 5, 39-80.) The "effective date" of this plan was to be January 1, 1939. Under its terms, the public holders of stock, or of stock-trust certificates, in certain lessor companies were to receive from the taxpayer, in satisfaction of their claims, a cash payment and securities of the new company, consisting of shares of participating preferred stock and of 3-6 percent "consolidated mortgage bonds," varying in amount according to the value of their interests in

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[4] These included the Philadelphia Rapid Transit Company, 27 lessor companies, and 37 companies whose stock was wholly owned either by Philadelphia Rapid Transit Company or by the lessor companies. (R. 4-5, 65-66.)

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the old companies. (R. 5-6, 49-50, 72.) Consolidated mortgage bonds were also to be distributed to the bondholders of two of the lessor lines, viz., the holders of Darby, Media and Chester Street Railway Company (Darby) 4½ percent first mortgage bonds, and holders of Doylestown and Willow Grove Railway Company (Doylestown) first mortgage 4 percent bonds. (R. 6, 52.) Other bondholders of the lessor lines were to receive new first and refunding 4 percent mortgage bonds issued by the taxpayer. (R. 51.) Other interest-bearing obligations of the predecessor companies were not to be affected by the reorganization plan, but were to remain outstanding and to be assumed by the taxpayer. (R. 48, 59-61, 73, 74-77.)

The controversy here arises with respect to the 3-6 percent consolidated mortgage bonds. "Fixed" interest of 3 percent was payable semi-annually on these bonds in any event; an additional contingent "income" interest, not to exceed 3%, was payable to the extent to which net income in any year was sufficient. (R. 47-48, 81-82; Ex. 7-G, pp. 71-73.) Coupons for the fixed and contingent interest were to be attached to the bonds. The bonds were to be dated January 1, 1939, the effective date of the plan, and were to mature on January 1, 2039. (R. 46-48, 81-89.)

On January 29, 1940, less than a month after it came into existence, the taxpayer executed and delivered $32,529,943.54 face amount of these consolidated mortgage bonds to the mortgage trustee

for authentication and distribution to the persons entitled to receive them. (R. 7-8.) The trustee in turn delivered $31,933,543 face amount of these bonds to the holders of stock and stock trust certificates in the lessor lines, and $596,400 face amount to the bondholders of the Darby and Doylestown lines. (R. 5-6, 9.) Simultaneously, the taxpayer delivered to the trustee its check for $966,952.30, representing the amount due on the fixed interest coupons for 1939. (R. 9-10.) Both coupons for the 1939 fixed interest were attached to the bonds delivered to the former stockholders in the lessor lines (R. 9), but, pursuant to an order of the court, the fixed interest coupons for the first half of 1939 had been detached before delivery from the bonds delivered to the Doylestown and Darby bondholders. (R. 6-7, Ex. Q, pp. 10685-10686.) Accordingly, the trustee distributed to the former group $958,006.30, representing the "fixed interest" for all of 1939, and to the Darby and Doylestown bondholders the remaining $8,946, representing "fixed interest" for the latter half of 1939. (R. 9.)

The apparent reason why the bankruptcy court ordered these fixed interest coupons detached from the bonds delivered to the old bondholders of the Darby and of the Doylestown lines is that each received, in 1939, the semi-annual interest on their old bonds, the payment, apparently, being made by the old company during the course of the receivership. In the case of the Darby line, the interest paid was due on July 1, 1939. (R. 6-7.)

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In the case of the Doylestown line, the interest was due on June 1, 1939 (R. 6), and these bondholders, by order of the bankruptcy court, received an additional cash payment of $500 from the taxpayer on January 29, 1940, representing 3 percent of the face amount of their new bonds for the period June 1, 1939, to July 1, 1939 (R. 6; Ex. Q, p. 10685).

The taxpayer, in addition, on June 28, 1940, delivered to the trustee its check in the amount of $819,754.58 for payment to the consolidated mortgage bondholders in satisfaction of the contingent interest coupons with respect to income earned by the predecessor company during 1939. This was in accordance with a report made to the taxpayer showing that the income earned during 1939 by the predecessor, the Philadelphia Rapid Transit Company, permitted a payment at the rate of 2.52 percent on the taxpayer's outstanding consolidated mortgage bonds. In computing the earnings of the Philadelphia Rapid Transit Company, this report disregarded the rentals payable in 1939 to the lessor lines (which, of course, had not been paid) and took no account of an interim cash payment which was made to certain lessor companies pursuant to an order of the bankruptcy court. (R. 10-11.)

The balance sheet with which the taxpayer opened its books in the late Spring of 1940, effective as of January 1, 1940, showed under "matured interest" an item which included the $966,952.30 obligation for the 1939 fixed interest coupons, and

also included the $500, previously mentioned, which was paid to the bondholders of the Doylestown line. (R. 8-9.) The taxpayer's books also showed under "accrued interest" an item of $820,225.18 representing the obligation to redeem the 1939 contingent interest coupons on these bonds, of which as already noted, $819,754.58 was ultimately paid. (R. 10.)

In its income tax return for 1940, the taxpayer, which reported its income and deductions on the accrual basis, claimed a deduction with respect to the consolidated bonds in the amount of $1,787,206.88, consisting of $966,952.30 and $500 which was paid on January 29, 1940, and of $819,754.58 which was paid on June 28, 1940, as described above. (R. 12; Ex. 10-J, Schedule 12.) Whether these items are properly deductible is the ultimate question for decision.[5]

During 1940, the taxpayer also accrued items for the two fixed interest coupons and for the contingent interest coupons for that year on the consolidated mortgage bonds. These items, aggregating $1,944,845.18, were also claimed as a deduction under the heading of "interest" in the taxpayer's 1940 return. The Commissioner has not questioned the correctness of this deduction. (R. 11-12; Ex. 10-J, Schedule 1, p. 3.)

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[5] The taxable year involved in these proceedings is 1942, where the taxpayer claimed a net operating loss deduction which was carried over from 1940. The ultimate issue involves the proper computation of the net operating loss in 1940 which may be carried over under Sections 23 (a) and 122, Internal Revenue Code (Appendix, *infra*).

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B. *The disputed payments represent a portion of the cost of property acquired by the taxpayer rather than deductible interest on an indebtedness*

Section 23 (b) of the Internal Revenue Code (Appendix, *infra*), provides for the deduction of "all interest paid or accrued within the taxable year on indebtedness * * *." The meaning of this section is clear. Deductible interest comprehends only those payments which are "compensation for the use or forbearance of money" (*Deputy* v. *DuPont*, 308 U. S. 488, 498); it is "the amount which one has contracted to pay for the use of borrowed money". *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 560. Accord: *Equitable Society* v. *Commissioner*, 321 U. S. 560, 564.

In the instant case no compensation was paid for the use or forbearance of money when the taxpayer, simultaneously with the execution and delivery of its bonds on January 29, 1940, purported to pay a full year's fixed interest for 1939.[6] Prior to the issuance of the bonds, the taxpayer was indebted to no one. Prior to that time, the taxpayer did not have the use or forbearance of anyone's money. The payment of $966,952.30 on January 29, 1940, could not possibly represent compensation for the taxpayer's use of borrowed money in 1939. Con-

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[6] As already noted, pp. 10-11, *supra*, only a half year's fixed interest and an additional $500 was paid on $596,400, face amount, of those bonds, which were delivered to bondholders of the Darby and Doylestown lines.

sequently, the liability which the taxpayer had listed on its opening books (effective even before the bonds had been issued) as "matured interest," could not be deductible, accrued interest, as that term is employed in the statute. The same observations are true with respect to the contingent interest for 1939, liability for which was accrued on the taxpayer's opening books for 1940, and payment of which was made on June 29, 1940. Here, too, the taxpayer was not compensating anyone for the use of funds which it borrowed in 1939.

It is not questioned that these were obligations which the taxpayer assumed on its organization; undoubtedly, they properly appeared as liabilities on its opening books. But they were not obligations for accrued interest deductible under Section 23 (b). They represented, instead, part of the obligations undertaken by the taxpayer in order to acquire the assets of the old companies. These payments were as much a part of the cost to the taxpayer of obtaining those assets as were the other cash payments which it made and the securities which it issued to effectuate the plan of reorganization. Such was the position taken by the dissenting judge below. (R. 99-100.)

Commissioner v. *Drovers Journal Pub. Co.*, 135 F. 2d 276 (C. A. 7), is persuasive that the taxpayer's obligation to redeem the 1939 coupons was not a liability for deductible interest. There, a subsidiary corporation issued its own securities, including interest bearing notes, to acquire the out-

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standing capital stock of the parent company. The notes were issued on December 7, 1937, but were dated January 1, 1937. Reversing the Tax Court, the Court of Appeals held that interest could not be deducted on the notes for the period which antedated their issue, saying (p. 279):

> It is certain that no interest can be paid for the use of money if there is no use of the money, and since no indebtedness was owing by the respondent to the preferred stockholders of Corn Belt Publishers, Inc., prior to December 7, 1937, the $28,000 could not be paid as compensation for pre-December 7 use of the $400,000 borrowed on the notes.

The courts have repeatedly struck down such attempts to claim as deductible interest payments which were actually part of the purchase price of acquired assets. *F. A. Gillespie & Sons Co.* v. *Commissioner*, 154 F. 2d 913 (C. A. 10), certiorari denied, 329 U. S. 781; *Rodney, Inc.* v. *Commissioner*, 145 F. 2d 692 (C. A. 2); *Hundahl* v. *Commissioner*, 118 F. 2d 349 (C. A. 5); *Autenreith* v. *Commissioner*, 115 F. 2d 856 (C. A. 3); *Commissioner* v. *Lincoln-Boyle Ice Co.*, 93 F. 2d 26 (C. A. 7); *Baltimore & O. R. Co.* v. *Commissioner*, 78 F. 2d 460 (C. A. 4); *Henrietta Mills* v. *Commissioner*, 52 F. 2d 931 (C. A. 4); *Daniel Bros. Co.* v. *Commissioner*, 28 F. 2d 761 (C. A. 5); *Pratt-Mallory Co.* v. *United States*, 12 F. Supp. 1020 (C. Cls.); *Medical Bldg. of Houston* v. *Commissioner*, decided November 10, 1943 (1943 P-H B. T. A. Memorandum Decisions,

par. 43,478). Cf. *Magruder* v. *Supplee,* 316 U. S. 394. See also *Lloyd* v. *Commissioner,* 154 F. 2d 643 (C. A. 3), certiorari denied, 329 U. S. 717.

To the extent that a contrary result was reached in *Commissioner* v. *Pressed Steel Car Co.,* 152 F. 2d 280 (C. A. 3); *Commissioner* v. *Columbia River P. Mills,* 126 F. 2d 1009 (C. A. 9); *Ernst Kern Co.* v. *Commissioner,* 1 T. C. 249; and *Oregon Pulp & Paper Co.* v. *Commissioner,* 47 B. T. A. 772, petition for review dismissed November 2, 1943, the decisions are demonstrably in error. An analysis of those cases will reveal that in each the interest which was permitted to be deducted with respect to a period which antedated the indebtedness should have been considered as an added cost of the assets acquired.

In the present case, it is impossible to escape the conclusion that when the taxpayer redeemed the 1939 coupons it was, in part, satisfying claims against the predecessor companies, thereby making one of the expenditures which enabled it to acquire the assets of those companies. This is fully apparent from a consideration of the reorganization plan. By selecting an effective date for the plan (and for the bonds) which was not dependent on the actual date of consummation, the plan of reorganization imposed an obligation on the taxpayer which was not different from that which it assumed when it obligated itself to distribute more than $2,200,000 in cash to the majority of persons who were entitled

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to acquire these bonds.[7] Certainly, there could be no contention that the latter liability accrued as a deductible item when the taxpayer came into being as a corporation; on the contrary, it is overwhelmingly plain that this was one of the costs of the taxpayer's acquiring the assets of these lessor companies and of satisfying the value of their claims in the bankruptcy proceedings. It was a capital expenditure, not a deductible expense.

If the effective date of the plan had been set to coincide with the date of consummation, and if, just prior to going into effect, the plan had been revised to provide that an additional amount of cash should be distributed by the new company to these security holders, there similarly could be no valid contention that the additional cash was deductible. This, too, would clearly be one of the costs incurred by the new company in acquiring the assets of the old companies. Yet the establishment of an effective date of a reorganization plan which, instead of coinciding with the date of consummation, will probably antedate it, and of issuing interest bearing securities dated as of the effective date, is essentially a method of providing that additional cash shall be distributed to the security holders in the event that the plan cannot be carried into effect until after the effective date has passed. While not a permissible method of decreasing the

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[7] The bondholders of the Darby and of the Doylestown lines received only new consolidated mortgage bonds, and did not share in the cash contribution.

tax liability of the new company, it is a sensible procedure, designed to maintain a fair and equitable scheme of distribution where litigation or other obstacles might prevent timely execution of the plan. It is a recognized and accepted technique in reorganization proceedings. See *Ecker* v. *Western Pacific R. Corp.*, 318 U. S. 448, 509-510; *Group of Investors* v. *Milwaukee R. Co.*, 318 U. S. 523, 529, 546; *R. F. C.* v. *Denver & R. G. W. Co.*, 328 U. S. 495, 521.

By approving and confirming the plan here, the District Court must have considered that it made adequate provision for the various security holders in the companies which were being reorganized, and that it recognized the relative priority of the claimants in accordance with the doctrine of *Northern Pacific Ry. Co.* v. *Boyd*, 228 U. S. 482; *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106; and *Consolidated Rock Co.* v. *DuBois*, 312 U. S. 510. The proponents, in drafting the plan, and the bankruptcy court, in evaluating it, could not know when the plan would eventually go into effect. This, of course, is true of most reorganization proceedings. If the plan did not provide for an effective date, and if the interest bearing securities were not to be issued as of that effective date, it is quite plain that any delay might require later revisions in the allocation of cash and securities in order to maintain the relative priority of the various claimants. Otherwise, the earnings of the company during the interval might ultimately inure to the primary

benefit of claimants having a lower order of priority, namely, the new common stockholders, and the plan would fail to recognize that the claims of senior security holders against the debtor have been augmented by the further passage of time during the continued course of the reorganization proceedings. By giving the plan an effective date, however, this can usually be avoided, for the bankruptcy court can consider whether the plan is fair and equitable as of the effective date, and the creditors having the highest priority, and entitled to the highest ranking securities (first mortgage bonds) in the new company, will receive additional cash payments, under the title of predated interest, the amounts payable being dependent on the length of time that elapses after the effective date. Even as between senior and junior bondholders, the selection of an effective date will help in maintaining the relative priority of their claims, dependent upon the interest rates established in the new senior and junior mortgage bonds.

In the present case, for example, of the various security holders affected by the reorganization, bondholders in several of the lessor companies had the face amount of their old bonds satisfied, dollar for dollar, by the issuance of new first mortgage bonds, bearing 4 per cent interest. This was evidently considered a complete satisfaction of their claims. (R. 51.) The claims of the stockholders of lessor lines were obviously considered inferior, for they were satisfied, in part, by the consolidated

mortgage bonds, which were junior to the first mortgage bonds (R. 46), and in part by preferred stock and a comparatively small amount of cash.[8] Moreover, the former stockholders of the old Transit Company received only common stock in the new corporation. (R. 50.) As between these groups, it is clear that the junior security holder ought not to obtain a better position by the passing of time, as would be true if the first mortgage bondholders were to receive nothing additional, and if the interim earnings could be accumulated to pay dividends on the new stock. Such disturbance of the relative priority of the claimants caused by the passage of time could be avoided by a last minute change in the plan, just prior to consummation, to provide for a new cash adjustment. It can also be avoided, normally, and more conveniently, by giving the plan a definite, effective date which will antedate the time when it is actually carried into effect.

What we emphasize is that these additional cash payments, even though spoken of as "interest" from the effective date of the plan to the time when consummated, are truly a part of the price paid by the new company to obtain the assets of the companies which were being reorganized. They do

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[8] The claims of the bondholders of the Darby and the Doylestown lines were evidently considered inferior to these, for they received only a portion of the face amount of their old bonds in consolidated mortgage bonds; they received no preferred stock and did not participate in the cash distribution provided for in the plan.

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not, for tax purposes at least, differ from the other cash payments scheduled to be made under the reorganization plan, simply because, as a matter of convenience in calculation and payment, they are denominated "interest." They are not, and cannot be, interest on borrowed funds for, until the plan was consummated, the taxpayer was not indebted to these security holders. Indeed, the stockholders of the lessor lines who received the majority of the consolidated mortgage bonds did not previously have an interest bearing claim, even as against the old companies. Their claim in reorganization was based only upon unpaid rentals owing from the old Transit Company and the value of their rights in the property to be acquired by the new company.

In this connection, it should be observed that the earnings of the predecessor company in 1939, as stated in the report which formed the basis for the computation of the amount owing by the taxpayer on the 1939 contingent "interest" coupons, showed a gross income of $5,836,729.49, and deductions (other than interest) of $2,549,616.09, leaving $3,287,113.40 available for fixed and contingent interest. Interest of $1,406,621.03 for 1939 was owing on bonds and other obligations of predecessor companies which were not affected by the reorganization but which were still outstanding and were assumed by the taxpayer. (R. 48, 59-61, 73, 74-77; Ex. 9-I.) The record is not clear whether this amount of interest was paid by the predecessor

in 1939, or by the taxpayer in 1940. At all events, *the operations of the predecessor in 1939 enhanced the receivership estate by a net amount of $1,880,492.43.* It is significant that $1,862,330 is the approximate amount of interest, both fixed and contingent, which the taxpayer paid for 1939 on its own first mortgage and consolidated mortgage bonds. This plainly demonstrates that what the taxpayer paid as 1939 "interest" was really the cost of the assets added to the receivership estate by the 1939 operations of the predecessor.

It would seem that the bankruptcy court also viewed the 1939 coupons as being part of the cost of satisfying creditors' claims and of acquiring the assets of the debtor companies. Nothing else will explain the treatment of the bondholders of the Darby and Doylestown lines. These bondholders, as has already been observed, p. 10, *supra,* had received a semi-annual interest payment on their old bonds during the reorganization proceedings in 1939. Although the plan itself had made no such provision, in the order confirming the plan the bankruptcy court required that one semi-annual, fixed interest coupon be detached from the new bonds delivered to these bondholders, and that a cash payment of $500 be made to the bondholders of the Doylestown line to adjust for one month's interest on the new bonds. Quite plainly, it was believed that a portion of their claims against the debtor companies had been satisfied by the interest payment received in 1939 and, accordingly, that

what the taxpayer was obligated to pay to receive the mortgaged assets should be proportionately reduced.

It is likewise significant that the Pennsylvania Public Service Commission did not view these disputed payments as being the kind of interest which should be deducted in determining the taxpayer's earnings for 1940 since, in accordance with the Commission's regulations, they were not permitted to be deducted as expenses in the taxpayer's accounts. (R. 11.)

C. *The lower court's decision is wrong in permitting essentially the same deduction to be taken successively by both the old company and the new company.*

That the Court of Appeals here reached the wrong conclusion is also evident from the anomalous results which its decision requires in this and similar situations. One such anomaly is that it permits essentially the same deduction to be taken in successive years by different taxpayers. Thus, in its tax return for 1939, the predecessor company accrued its liability for a full year's interest on the mortgage bonds of the Darby and Doylestown lines. (Resp. Ex. R, Schedule 1, p. 5.) Although it had actually paid only a half year's interest on those bonds, it was entitled to deduct the full amount of the accrued liability since it, too, was on the accrual basis. It also accrued and deducted its liability for the full amount of the

unpaid rentals due to the various lessor lines in 1939. (Resp. Ex. R, Schedule 1, p. 7 and Schedule 1A.) We believe that this was also a proper deduction. I.T. 3635, 1944 Cum. Bull. 101.[9]

If the court below is correct, and if the taxpayer is also entitled to accrue as deductible interest the amount of its liability on the 1939 coupons to the old stockholders of the lessor lines (in lieu of 1939 rentals) and to the old mortgage bondholders of the Darby and the Doylestown lines (for 1939 interest), it is plain that a double, successive deduction has been allowed with respect to what is essentially the same liability. A similar opportunity for double deductions would arise whenever there is a reorganization and where the accrual method of accounting is employed. Yet, it is familiar law that the revenue acts should be construed so as not to permit double deductions. *McLaughlin* v. *Pacific Lumber Co.*, 293 U. S. 351, 355-356; *Ilfeld Co.* v. *Hernandez*, 292 U. S. 62, 68; *United States* v. *Ludey*, 274 U. S. 295, 301.

The court below thought it significant that "neither the present taxpayer nor any of its predecessors was in a position to take advantage of a 1939 deduction for the interest payments in question." (R. 99.) What it failed to observe, however, is that the predecessor company was in

[9] While an Internal Revenue Agent proposed to disallow the accrual of the rentals for 1939, it does not appear that his recommendations were ever acted on by the Commissioner. (R. 15-16.) I.T. 3635, *supra*, would indicate that his recommendations were wrong in this respect.

a position to take, and did take, a deduction for its rental and interest obligations—the same obligations which were satisfied, whether in whole or in part, by the taxpayer's 1939 coupons. The fortuitous circumstances that the predecessor company had no net taxable income in 1939 is of no consequence, for it is quite possible that other predecessor corporations in such circumstances might have net income and double tax benefits would be possible as a result of such double, successive deductions.

D. *The error in treating the 1939 coupons as "interest" is further demonstrated by the fact that the taxpayer was allowed to accrue interest deductions for two years in one year—a result that is inconsistent with the accrual system of accounting*

Another anomalous result of the lower court's treatment of the disputed payments as interest is that the taxpayer is permitted to accrue the liability for two years' interest in one year. Thus, in its tax return for 1940, the taxpayer accrued the full amount of its liability for the 1940 fixed and contingent interest coupons on the consolidated mortgage bonds. (R. 11-12; Ex. 10-J, Schedule 1, p. 3.) To permit the taxpayer, however, as the decision below does, also to accrue in 1940 what purports to be an interest liability for 1939 offends a basic principle of tax accounting.

Interest is a liability which accrues ratably

with the passage of time. It accrues as a liability, not when payment is made, but during the period of the borrowing for which the payment is to be made. The basic principles in this respect were stated with unusual clarity in *Miller & Vidor Lumber Co.* v. *Commissioner,* 39 F. 2d 890, 892 (C.A. 5), certiorari denied, 282 U. S. 864:

> Each year's interest was ratably earned by the use of the principal sum in the business of the taxpayer during the year of its use. It was an expense of creating the income for each separate year, and the net income of the business for a particular year could be ascertained only by deducting from gross income the item of annual interest. The year of the payment of the interest and the year when the interest matured have no importance, where the accounting is on the accrual basis. Scientific accounting requires the deduction to be made from the gross income, which the item of expense helped to create, and that requires the deduction for annual interest to be made from the gross income of the year in which the principal served to create it.

Accord: *Warner Co.* v. *Commissioner,* 11 T.C. 419, 431; *B. F. Goodrich Co.* v. *Commissioner,* 1 T.C. 1098, 1101; *Higginbotham-Bailey-Logan Co.* v. *Commissioner,* 8 B.T.A. 566, 577; *McIntosh & Seymour Corp.* v. *Commissioner,* 2 B.T.A. 953, 956-957.

Under correct principles of accounting it is impossible, accordingly, that interest for more than one year can be accrued in one year when the

liability is not in dispute. Net income on an annual basis could not be clearly reflected by an accounting method which permitted such an aggregation of deductions. See Section 43, Internal Revenue Code (Appendix, *infra*); Section 19.43-2, Treasury Regulations 103 (Appendix, *infra*).

The taxpayer, moreover, was not even consistent in the manner in which it treated these items in its 1940 tax return, for, while it deducted the accrued liability for both the 1939 and 1940 coupons on the consolidated mortgage bonds, it did not assert a similar, double deduction with respect to the interest on the first mortgage bonds; instead, it only deducted the accrued liability for the 1940 interest on those bonds. (R. 29; Ex. 10-J, Schedule 1, p. 3.)[10] We submit that the taxpayer was correct in claiming a deduction for a single year's interest on the first mortgage bonds, but was wrong in claiming a deduction for two years' interest on the consolidated mortgage bonds.

The court below attempted to answer this by drawing an analogy between the situation here and one where the interest coupons for the first year "were just double the later ones in amount." (R. 98.) Apart from the obvious fact that the 1939 "interest" was never intended as compensation for the use of borrowed money during the first year

[10] The taxpayer deducted $75,123.82 as interest in 1940 on the first mortgage bonds. This represents one year's interest of 4 percent on approximately $1,897,860, face amount of these bonds, authorized to be issued and outstanding by the reorganization plan. (R. 51.)

(1940), the court's assumption that in the supposed situation the "double" amount would be fully deductible merely begs the question. If part of the "double" amount truly represents part of the purchase price, as we submit is the case here, it does not become transmuted into deductible interest simply because the parties have described the obligation as though it were interest. *Autenreith* v. *Commissioner*, 115 F. 2d 856, 858 (C. A. 3); *Pratt-Mallory Co.*, v. *United States*, 12 F. Supp. 1020, 1021 (C. Cls.). See *Magruder* v. *Supplee*, 316 U. S. 394, 399. The tax result cannot be changed because the parties chose to evidence two separate obligations by a single coupon. Further, if part of the "double" amount, instead of representing a portion of the purchase price, constituted a prepayment of interest for the entire period (see point II, *infra*, pp. 28-29), the obligor would not be relieved of the necessity of amortizing this over the life of the obligation by the simple expedient of pretending that a "double" rate of interest is payable for the first year.

II

If the Liability for the Disputed Payments Represents Interest, It Is a Prepayment of Interest Which Must Be Accrued Ratably Over the Life of the Indebtedness

We believe that the position developed in point I —that the amounts in question do not represent deductible interest—is the only permissible one. If we are mistaken, and if the 1939 "interest"

coupons truly represented an obligation to pay compensation for the use of borrowed funds, the decision below would, nevertheless, still be wrong in permitting the entire liability to be accrued and deducted in one year.

It has already been adequately demonstrated that the taxpayer did not and could not have an obligation to pay compensation for funds borrowed in 1939, since the taxpayer's indebtedness did not exist until the bonds were issued in 1940. If the taxpayer's obligation with respect to the 1939 coupons did actually represent compensation for the use of borrowed funds, it could only represent compensation for future use. The most that it would constitute, then, would be a partial prepayment of interest, similar to the issuance of bonds at a discount. As such, it would be deductible, not in one year, but ratably over the entire period of the obligation, in this case during a period of 99 years. *Helvering* v. *Union Pacific Co.*, 293 U. S. 282; Section 19.22(a)-18(3) (a), Treasury Regulations 103 (Appendix, *infra*). A prepayment of interest, like other prepaid expenses, cannot be deducted in full in the year of payment, but must be apportioned over the entire period covered by the expenditure. *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, 285-286; *Commissioner* v. *Boylston Market Ass'n*, 131 F. 2d 966 (C. A. 1), and cases there cited at page 968. This, it should be noted, is as applicable to taxpayers who use the cash dis-

bursements and receipts method of accounting, as it is to those who employ the accrual method.

III

In Making a Timely Deficiency Determination for 1942, the Commissioner Was Not Barred from Ascertaining the Correct Amount of the Taxpayer's Net Loss in 1940 Which Could Be Carried Over to 1942

In the lower courts, the taxpayer contended that, regardless of whether it was actually entitled to these deductions for 1940, they could not be questioned in this case because of the statute of limitations. Neither the Tax Court nor the Court of Appeals found it necessary to pass on this argument.

The taxable year involved in these proceedings is 1942. It is not disputed that the Commissioner's deficiency determination for that year was timely. The proper amount of interest which may be deducted by the taxpayer for 1940 is involved only because the taxpayer is asserting a net operating loss deduction in 1942 under Section 23 (s) of the Internal Revenue Code (Appendix, *infra*), which it seeks as a carry-over from 1940, pursuant to Section 122 of the Internal Revenue Code (Appendix, *infra*). The taxpayer's argument seems to be that, since the Commissioner did not disallow the deduction for interest which it claimed in its 1940 return prior to the expiration of the three year statute of limitations, that deduction was "allowed by this chapter," as that term is used by Section 122 (a) in defining "net operating loss." The taxpayer

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contends that this construction is supported by *Virginian Hotel Co.* v. *Helvering*, 319 U. S. 523. Accordingly, so it is argued, the amount of the loss carry-over from 1940 which can be deducted in 1942 cannot be questioned by the Commissioner, even though 1942 is still an open year.

1. A short answer to this contention is that the statute of limitations (Section 275 (a), Internal Revenue Code (Appendix, *infra*)) provides only that taxes shall be assessed within three years and that no court proceedings for collection without assessment shall be instituted after that time. The Commissioner is not, however, attempting to assess or collect any tax liability for 1940, which is all that the statute forbids. He has (R. 13) "disallowed" the asserted deduction for 1940 only to the extent that it affects the proper tax liability for 1942.[11] There is nothing in Section 275 (a) or in any other section to prevent such a disallowance. See *Commissioner* v. *Disston*, 325 U. S. 442, 449, where the Court, speaking of the similar statute of limitations applicable to the gift tax, said that it—

> simply prevents assessment and collection of a tax for a year barred by the statute. The statute does not purport to preclude an examination into events of prior years for the purpose of correctly determining gift tax liability for years which are still open. * * *

[11] Apart from the question of limitations, the Commissioner was certainly not disabled from reopening the 1940 returns for the purpose of disallowing a deduction which he had previously approved. This question was set at rest a number of years ago. *Burnet* v. *Porter*, 283 U.S. 230.

Accordingly, even if the taxpayer's construction of Section 122 were correct, the ultimate conclusion which it urges would be without foundation since the Commissioner has, in fact, properly disallowed these items. Cf. *Lord Forres* v. *Commissioner*, 25 B. T. A. 154; *Mitchell* v. *Commissioner*, 27 B. T. A. 645; *Alabama Mineral Land Co.* v. *Commissioner*, 28 B. T. A. 586.[12]

2. Moreover, it seems clear from the context of Section 122(a) that the word "allowed" refers merely to deductions that are legally permissible under the statute, and not to administrative action in approving or failing to disapprove a deduction claimed by a taxpayer. Consequently, the *Virginian Hotel* case, relied upon by respondent, can have no application here.

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[12] Section 272 (g) of the Internal Revenue Code (26 U.S.C. 1946 ed., Sec. 272), empowers the Tax Court, in redetermining a deficiency for a particular year, to "consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency," though the Tax Court has no jurisdiction to determine whether the tax for such other years has been overpaid or underpaid.

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CONCLUSION

The decision of the Court of Appeals should be reversed.

Respectfully submitted,

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NOVEMBER, 1949.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness * * *.

* * * * *

(s) [as added by Section 211 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862.] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 43.)

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SEC. 122 [as added by Section 211 (b) of the Revenue Act of 1939, *supra*]. NET OPERATING LOSS DEDUCTIONS.

(a) [as amended by Section 105 (e)(3)(A) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [as amended by Section 153 (a) of the Revenue Act of 1942, *supra*] *Amount of Carry-Back and Carry-Over.*—

* * * * *

(2) *Net Operating Loss Carry-Over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year * * *.

* * * * *

(26 U.S.C. 1946 ed., Sec. 122.)

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return

was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(26 U. S. C. 1946 Ed., Sec. 275.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22(a)-18. *Sale and purchase by corporation of its bonds.*—

* * * * *

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

* * * * *

SEC. 19.43-2. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. * * *

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